

Message Text

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TO AMEMBASSY TEHRAN NIACT IMMEDIATE

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FOR POATS AND NAAS FROM BEALES

E.O. 11652: N/A

TAGS: ENRG, IR

SUBJECT:ERC STATEMENT ON LNG IMPORT POLICY

REFERENCE: STATE 194702

1. FOLLOWING IS TEXT OF ERC POLICY STATEMENT ISSUED
AUGUST 5 ON LNG IMPORT POLICY:

BEGIN TEXT:

BACKGROUND. IN HIS FEBRUARY ENERGY MESSAGE, THE PRESIDENT
ANNOUNCED A STRONG CONCERN ABOUT THE NATION'S GROWING
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DEPENDENCE UPON IMPORTED LIQUEFIED NATURAL GAS (LNG) AND
DIRECTED THE ENERGY RESOURCES COUNCIL (ERC) TO IMPLEMENT
A NATIONAL LNG POLICY. THE POLICY ANNOUNCED IN FEBRUARY
WOULD ENABLE THE UNITED STATES TO IMPORT ONE TRILLION

CUBIC FEET (TCF.) OF LNG BY 1985 WITHOUT BECOMING OVERLY DEPENDENT ON FOREIGN SOURCES. THE ERC WAS ALSO DIRECTED TO REVIEW THE ACCEPTABLE LEVEL OF DEPENDENCE BASED UPON CURRENT ESTIMATES OF NATURAL GAS PRODUCTION.

SINCE THE ENERGY MESSAGE, THE FOLLOWING HAS DEVELOPED.

-- THE ERC LNG IMPORT TASK FORCE HAS COMPLETED AN IN-DEPTH ANALYSIS OF THE DEPENDENCE ISSUE, NEED FOR NATURAL GAS, AND ECONOMIC CRITERIA FOR ASSESSING DEPENDENCE.

-- THE ERC HELD PUBLIC HEARINGS IN WASHINGTON, D. C. AND LOS ANGELES TO ASCERTAIN THE VIEWS OF BUSINESS, CONSUMER, ENVIRONMENTAL, LABOR, AND GOVERNMENT OFFICIALS.

-- THE FEDERAL POWER COMMISSION (FPC) HAS NOW APPROVED 0.4 TCF. OF LNG IMPORT PROJECTS, AND OVER 3 TCF. OF ADDITIONAL PROJECTS ARE PENDING OR IN THE PLANNING STAGE.

-- NO LONG-TERM LEGISLATED NATURAL GAS PRICE DEREGULATION HAS BEEN FORTHCOMING.

SUMMARY OF KEY CONCLUSIONS

THE ERC ANALYSIS FOCUSED ON A NUMBER OF KEY RISKS ASSOCIATED WITH LNG IMPORTS. SOME OF THESE RISKS WOULD TEND TO DISCOURAGE NEW PROJECTS, WHILE OTHERS WOULD LEAD TO GREATER ACCEPTABILITY.

-- RISK OF SUPPLY DISRUPTION

THE ERC CONCLUDED THAT THE RISK OF A SUPPLY DISRUPTION, EITHER AS A RESULT OF POLITICAL ACTION (SUCH AS AN OIL AND GAS EMBARGO OR GAS EMBARGO ONLY) OR BECAUSE OF TECHNICAL PROBLEMS, WARRANTS GOVERNMENT ACTION. THERE ARE ONLY A LIMITED NUMBER OF COUNTRIES LIKELY TO EXPORT SIGNIFICANT VOLUMES OF LNG TO THE UNITED STATES IN THE UNCLASSIFIED

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NEXT TEN YEARS. THESE NATIONS HAVE A DIVERSE SET OF POLITICAL AND ECONOMIC INTERESTS. THUS, SUPPLY DIVERSIFICATION WOULD REDUCE THE IMPACT OF A DISRUPTION.

THE TASK FORCE BELIEVES THAT IT WOULD BE EASIER TO TARGET AN LNG EMBARGO TO ONE PARTICULAR COUNTRY THAN TO TARGET AN OIL EMBARGO. THIS POSSIBILITY EXISTS BECAUSE THERE ARE LARGE CAPITAL INVESTMENTS, LONG-TERM CONTRACTS, SOPHISTICATED TECHNOLOGY, AND DEDICATED MARKETS INVOLVED WITH LNG PROJECTS.

WHILE THE LARGE CAPITAL COSTS OF LNG PROJECTS ORDINARILY WOULD EXERT PRESSURE ON PRODUCERS TO MEET CONTRACTED

DELIVERIES TO SATISFY DEBT SERVICE OBLIGATIONS, SUCH ECONOMIC CONSIDERATIONS MAY NOT PREVENT A POLITICALLY-MOTIVATED CUTOFF. IN SOME COUNTRIES, FINANCIAL NEEDS MAY MAKE IT DIFFICULT TO SUSTAIN AN LNG EMBARGO OVER A LONG PERIOD.

WHILE LNG IS A REASONABLY DIFFICULT SUBSTANCE TO PROCESS, HANDLE, STORE, AND TRANSPORT, LONG-TERM DISRUPTIONS OF SUPPLY FOR TECHNICAL REASONS ARE NOT LIKELY. TECHNICAL PROBLEMS EXPERIENCED EARLIER HAVE BEEN LARGELY OVERCOME; HOWEVER, START-UP PROBLEMS COULD OCCUR IN COUNTRIES THAT ARE NOT EXPERIENCED WITH LNG TECHNOLOGY. TECHNICAL PROBLEMS IN THE UNITED STATES' HANDLING OF LNG ARE POSSIBLE, BUT HIGHLY UNLIKELY.

THE IMPACT OF A SUPPLY DISRUPTION DEPENDS UPON MANY FACTORS, INCLUDING IMPORT DEPENDENCE IN EACH REGION. DEPENDENCY UPON IMPORTED GAS FROM APPROVED AND PENDING PROJECTS (IF ALL COME TO FRUITION) COULD RANGE FROM 15-30 PERCENT IN EACH REGION RECEIVING LNG IMPORTS; HOWEVER, SOME INDIVIDUAL GAS DISTRIBUTION COMPANIES COULD HAVE HIGHER DEPENDENCE. IF NATURAL GAS PRICES REMAIN REGULATED, MOST OF THE LNG IMPORTS WOULD BE NEEDED TO SERVE HIGH PRIORITY (RESIDENTIAL AND SMALL COMMERCIAL) CUSTOMERS AND VERY LITTLE, IF ANY, FOR NEW GROWTH. ON THE OTHER HAND, QUICK DEREGULATION WOULD REQUIRE LITTLE OF THE IMPORTED LNG FOR HIGH PRIORITY NEEDS AND CONSIDERABLE AMOUNTS FOR UNCLASSIFIED

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NEW GROWTH.

-- RISK OF ARBITRARY PRICE HIKES.

THE PRICE OF RECENTLY NEGOTIATED LNG PROJECTS HAS BEEN ABOUT DOLS 1.30 PER MILLION BTU (MMBTU) AT THE EXPORTING COUNTRY, WITH ESCALATORS. AFTER ADDING TRANSPORTATION AND REGASIFICATION COSTS, THE LNG DELIVERED PRICE IS TYPICALLY ABOUT DOLS 2.50 -DOLS 3.00/MMBTU.

SINCE LNG CONTRACTS ARE LONG-TERM, WITH DEDICATED FACILITIES, THERE IS A RISK OF ARBITRARY PRICE HIKES (WHICH OVER TIME AS FACILITIES ARE PUT IN PLACE). THE BASE PRICE FOR MOST LNG CONTRACTS IS NOW BEING LINKED TO CURRENCY FLUCTUATIONS AND THE PRICE OF SUBSTITUTE FUELS. PREVIOUS CONTRACTS HAVE BEEN RENEGOTIATED AS ENERGY PRICES HAVE INCREASED, AND THERE IS NO INSURANCE AGAINST PRICE HIKES, EXCEPT THE COMMERCIAL INTEGRITY OF THE PRODUCER COUNTRY.

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-- RISK OF INSUFFICIENT NATURAL GAS SUPPLY

ALL ANALYTICAL WORK POINTS TO THE HIGH PROBABILITY OF SIGNIFICANT SHORTFALLS OF NATURAL GAS IN THE NEXT TEN YEARS. THE UNCERTAINTIES ASSOCIATED WITH PRICE, RESERVES, LEASING POLICY, AND THE DELIVERY OF ALASKAN NATURAL GAS MAKE IT DIFFICULT TO PROJECT DOMESTIC PRODUCTION. NATURAL GAS IS A VITAL FUEL, USED BY OVER 40 MILLION RESIDENCES AND 200,000 INDUSTRIAL CONSUMERS. CONTINUING AND GROWING CURTAILMENTS IN THE INTERSTATE MARKET WILL LEAD TO FURTHER RELOCATION OF INDUSTRIAL USERS, AND POSSIBLY RESIDENTIAL CUTOFFS. FURTHERMORE, SIGNIFICANTLY REDUCED VOLUMES OF NATURAL GAS IN PIPELINES WILL LEAD TO GREATER UNIT COSTS AS PIPELINE CAPACITY WOULD BE UNDERUTILIZED.

LNG IMPORTS COULD ALLEVIATE, BUT NOT ELIMINATE, THESE EXPECTED SHORTAGES. SOME OF THE LNG IMPORTS MAY BE NEEDED TO SUPPLY RESIDENTIAL AND SMALL COMMERCIAL USERS. HOWEVER, THE USE OF LNG FOR SUCH CUSTOMERS PRESENTS A POLICY DILEMMA. THE IMPACTS OF INTERRUPTION ON THE RESIDENTIAL

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MARKET ARE POTENTIALLY SEVERE, BUT THE LACK OF GAS CAN HAVE SIMILARLY SEVERE EFFECTS ON A MARKET WITHOUT ALTERNATE FUEL CAPABILITY.

POLICY SUMMARY.

LEVEL OF DEPENDENCE.

THE ERC CONCLUDES THAT LNG IMPORTS ARE NEEDED AS A SUPPLEMENTAL SOURCE OF NATURAL GAS, BUT ALSO THAT THE UNITED STATES MUST LIMIT ITS LONG-RUN DEPENDENCE ON ALL ENERGY IMPORTS, INCLUDING LIQUEFIED NATURAL GAS.

AFTER CONSIDERATION OF A RANGE OF ALTERNATIVES, THE ERC HAS DECIDED TO RECOMMEND TO THE FEDERAL POWER COMMISSION THAT LNG IMPORTS FROM A SINGLE COUNTRY SHOULD BE LIMITED TO 0.8-1.0 TCF./YR. FOR NATIONAL SECURITY REASONS. FURTHER, ABOUT 2 TCF./YR. ARE AN ACCEPTABLE NATIONAL LEVEL OF IMPORT DEPENDENCY WITHIN THE SPECIFIC COUNTRY LIMITS SET ABOVE.

THIS POLICY IS AIMED AT ENCOURAGING DIVERSIFICATION OF SOURCES AND AT FACILITATING ATTAINMENT OF THE NATIONAL TARGET LEVEL. THE TARGET OF 2 TCF./YR. IS NOT A QUOTA, BUT REPRESENTS AN ACCEPTABLE LEVEL OF NATIONAL DEPENDENCY (ABOUT 10 PERCENT OF EXPECTED NATURAL GAS DEMAND), WHICH COULD CHANGE DEPENDING UPON DOMESTIC POLICY OCCURENCES.

THE ERC ALSO RECOMMENDS THAT THOSE PROJECTS WITH THE MOST DESIRABLE PRICING AND PRICE ESCALATION PROVISIONS FOR U. S. CONSUMERS AND PROJECTS WHICH AFFORD THE GREATEST

ASSURANCE OF UNINTERRUPTED SUPPLY FLOW SHOULD BE ACTED UPON EXPEDITIOUSLY BY THE FPC, PROVIDED THAT THEY ARE SOUND VENTURES IN ALL OTHER RESPECTS.

THE ERC'S RECOMMENDATION DOES NOT REPRESENT A MANDATORY REQUIREMENT FOR THE FEDERAL POWER COMMISSION. RATHER, THE EXECUTIVE BRANCH WOULD PRESENT TESTIMONY AT FPC HEARINGS ON PROPOSED LNG IMPORT PROJECTS. ALTHOUGH USE OF SECTION 232 OF THE TRADE EXPANSION ACT WAS REJECTED AS A MEANS FOR CONTROLLING LNG IMPORTS, IT COULD BE APPLIED

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IF FUTURE IMPORT PROJECT APPROVALS APPEAR TO THREATEN THE NATION'S SECURITY.

PRICING

THE ERC CONCLUDES THAT ROLLED-IN PRICING FOR EXISTING HIGH PRIORITY CUSTOMERS AND INCREMENTAL PRICING FOR LOWER PRIORITY OR NEW USERS ARE DESIRABLE WHERE ADMINISTRATIVELY FEASIBLE. THIS POLICY STATEMENT IS INTENDED AS A RECOMMENDATION FOR THE FPC AND STATE AND LOCAL AUTHORITIES. THE ERC WILL CONTINUE TO REVIEW THE PRICING ISSUE IN THE CONTEXT OF ALL NATURAL GAS SUPPLEMENTAL FUELS.

NEW NATURAL GAS SUPPLIES HAVE TRADITIONALLY BEEN PRICED ON A "ROLLED-IN," OR AVERAGED BASIS TO THE CONSUMER. AN ALTERNATE APPROACH WOULD BE TO PRICE THE SUPPLIES TO THE CONSUMER ON A MARGINAL OR "INCREMENTAL" BASIS, IN ORDER TO PRESENT THE CONSUMER WITH THE FULL ECONOMIC COST OF EACH NEW SUPPLY SOURCE.

PRELIMINARY ANALYSIS SHOWS THAT THE METHOD OF PRICING COULD AFFECT THE SIZE OF THE LNG IMPORT MARKET, AND WOULD AFFECT THE SECTORAL COMPOSITION OF DEMAND. IT IS CLEAR THAT LNG IMPORTS NEEDED FOR EXISTING HIGH PRIORITY RESIDENTIAL AND COMMERCIAL CUSTOMERS CANNOT REALISTICALLY BE PRICED ON AN INCREMENTAL BASIS AT THE RETAIL LEVEL. SUCH A PRICING TREATMENT MIGHT NOT BE ADMINISTRATIVELY FEASIBLE, AND SOCIAL INEQUITIES WOULD INEVITABLY APPEAR TO RESULT FROM ANY ATTEMPT TO DRAW DISTINCTIONS, SUCH AS FORCING SOME EXISTING RESIDENTIAL CUSTOMERS TO PAY FOR LNG AT A MULTIPLE OF THE PRICE OF DOMESTIC GAS EXPERIENCED BY OTHER RESIDENTIAL CUSTOMERS.

THE ERC BELIEVES THAT EXPENSIVE, RELATIVELY INSECURE LNG IMPORTS PROBABLY SHOULD NOT BE MADE AVAILABLE AT ROLLED-IN PRICES TO LOWER PRIORITY DOMESTIC USERS, OR IN SUPPORT OF NEW GROWTH. ROLLING-IN PRICES MASKS TO THE USERS THE FULL ECONOMIC AND SECURITY COSTS OF THE RESOURCE, AND PROVIDES DISINCENTIVES TO DOMESTIC SUPPLY DEVELOPMENT.

THERE REMAIN SEVERAL COMPLEX ISSUES DEALING WITH INTER-
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MEDIATE CATEGORIES OF USERS, PROVISIONS FOR CURTAILMENT,
AND COORDINATION WITH STATE AND LOCAL AUTHORITIES.
INCREMENTALLY PRICED GAS WOULD PROBABLY HAVE TO BE KEPT
FREE FROM CURTAILMENT IN ORDER TO HAVE A VIABLE MARKET;
YET, SUCH A POLICY WOULD FORCE GAS TO LOWER PRIORITY USERS
AND COULD RESULT IN INEQUITIES. MOREOVER, UNLESS
INCREMENTAL PRICING WERE MANDATED ALL THE WAY TO THE
BURNER TIP, WHICH MEANS CONSISTENT POLICIES AT THE STATE
AND LOCAL LEVELS, ITS EFFECTIVENESS AS A MEANS TO CONTROL
IMPORT QUANTITIES COULD BE LARGELY OFFSET.

GOVERNMENT FINANCIAL ASSISTANCE FOR LNG VENTURES

THE MARITIME ADMINISTRATION (MARAD) AND EXPORT-IMPORT
BANK HAVE PROVIDED GOVERNMENT FINANCIAL ASSISTANCE TO LNG
PROJECTS. MARAD MAY GRANT SHIP CONSTRUCTION SUBSIDIES
AND GUARANTEES FOR U. S. BUILT LNG TANKERS. IT HAS
APPROVED ALMOST DOLS 200 MILLION IN TANKER SUBSIDIES AND
ABOUT ONE BILLION DOLLARS IN MORTGAGE GUARANTEES. IN THE
ABSENCE OF U. S. SUBSIDIES, TANKERS WOULD BE AVAILABLE
ELSEWHERE; THUS, MARAD SUPPORT IS NOT ESSENTIAL TO LNG
VENTURES. ITS SUPPORT IS USED TO ASSIST THE U. S. SHIP-
BUILDING INDUSTRY IN COMPETITION WITH OTHER NATIONS.
THE ERC FINDS NO REASON TO RECOMMEND MODIFICATION OF THE
ON-GOING MARAD POLICIES WITH RESPECT TO LNG TANKERS.

THE EXPORT-IMPORT BANK PROVIDES LOANS AND GUARANTEES FOR
OVERSEAS LNG FACILITIES. LOANS HAVE BEEN GRANTED FOR GAS
FIELD FACILITIES AND PIPELINE COMPRESSOR STATIONS, WITH A
TOTAL EXPOSURE OF ABOUT DOLS 350 MILLION. ITS SUPPORT FOR
TRANSACTIONS IS CONDITIONED BY APPROVAL FROM AN INTER-
AGENCY ADVISORY COMMITTEE TO INSURE THAT LENDING MEETS
NATIONAL POLICY OBJECTIVES. THE ERC BELIEVES THAT THIS
MECHANISM IS SUFFICIENT FOR PROVIDING A TIMELY AND
INFORMED PROJECT REVIEW WHICH WILL MEET THE CONCERNS OF
THE EXECUTIVE BRANCH.

CONTINGENCY PLANNING

THE ERC BELIEVES THAT THERE IS A NEED FOR CONTINGENCY
PLANS PRIOR TO THE FPC'S APPROVAL OF PROSPECTIVE PROJECTS,
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AND THAT SUCH PLANS SHOULD BE REQUIRED BY THE FPC. A
PROJECT CONTINGENCY PLAN WOULD ENSURE CONTINUITY OF GAS
SUPPLY TO HIGH-PRIORITY CUSTOMERS FOR A SPECIFIED PERIOD.
THE PLANS COULD CONSIST OF ANY ONE OR A COMBINATION OF

UNDERGROUND AND LNG STORAGE, EXCHANGE AGREEMENTS THROUGH
INTERCONNECTIONS, CURTAILMENTS OR CUTOFF OF PREDETERMINED
LOWER PRIORITY USERS ON THE SYSTEM, AVAILABILITY OF STAND-
BY SUPPLEMENTAL SOURCES OF NATURAL GAS INCLUDING SYNTHETIC
GAS, CONSERVATION, OR ANY OTHER APPROPRIATE MECHANISM OR
PROCEDURES.

SITING AND SAFETY CONCERNS

ALTHOUGH THE FEDERAL POWER COMMISSION HAS JURISDICTION
OVER SITE SELECTION OF LNG IMPORT FACILITIES, THERE ARE
FRAGMENTED AND OVERLAPPING RESPONSIBILITIES FOR LNG SITING
AND SAFETY AMONG FEDERAL AGENCIES AND TO A CERTAIN EXTENT
AMONG STATE GOVERNMENTS. THE ERC HAS AGREED TO ADDRESS
THE ADMINISTRATIVE AND LEGAL PROBLEMS ASSOCIATED WITH THIS
ISSUE. WORKING WITH THE FPC AND STATE AND LOCAL AUTHORI-
TIES, THE ERC LNG IMPORT TASK FORCE WILL REPORT TO THE ERC
ON ANY EXPEDITING ACTIONS THAT CAN BE TAKEN, OR ANY
FURTHER ANALYSIS NEEDED.

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